WHAT IS PROFITABILITY?

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We all know what profit is: the surplus left over from revenue after covering expenses. Profitability is the measure of profit generated on an ongoing basis. Profit is generally measured in dollar terms; profitability is measured as a percentage of sales. You need to focus on both.

For many small businesses, profit equals the owner’s paycheck. If your profitability from operations doesn’t generate enough cash flow, you don’t get paid. The first step is to figure out how much you need to pay yourself to cover your basic needs and desired lifestyle, savings and retirement, and to pay your taxes. Then, figure out how much money your business needs to bring in to cover its expenses and pay you this amount.

This is an eye-opening experience for business owners. Your initial reaction may be dismay: How can I ever bring in that much revenue? Am I doomed to just scrape by? But, given your financial goals, you can begin looking seriously at how to restructure your business to give you what you need financially or else get out of it and go on to something else.

Profit is more than your pay

Even if you are a sole proprietor, learn to view profit as separate from what you pay yourself. Pretend that your company is a corporation, where you earn a regular salary, and that makes a profit beyond that. You get paid to work there, and as owner, you expect a profit dividend.

Profit is more than money

Here’s how small businesses should look at profitability:
Profit is **ROI** return on investment. You (and perhaps others) put capital into your business and you expect to get it back someday with a suitable rate of return. For an established yet vulnerable small business, a suitable ROI can be from 20% to 30% per annum.

Profit is **ROE** return on effort. Many people start their businesses largely with sweat equity, putting in thousands of hours of their own time unpaid to get the business up and running. Can you ever recoup the value of your time?
A business run by the owner should look at profit as the financial return per unit of your effort. For example, suppose you work 2,000 hours in a year, and your company’s profit is $250,000. For that year, you could say that you had a return of $125 for each hour you put in.

If you want to operate with greater ease, make sure you don't increase profit by dint of harder work and longer hours. More on this in chapter 11 of my book How to Grow Your Business without Driving Yourself Crazy in the section on Leverage Your Effort.

Profit is a tuning fork. It tells you how well tuned your business instrument is. When you are doing things right working productively and cost-effectively, selling the right things to the right people, serving your customers well, treating your own people well profit is the measure that amply demonstrates that.

The opposite is also true. When your business is not tuned properly, it sounds the discordant notes of low productivity, unhappy employees, dwindling customer base, and mounting losses. Profit is acknowledgement that the business is tuned properly.

Profit is flow. Profit provides the surplus that helps you weather the lean times. Profit allows you to be generous.

Profit is energy. Many small business owners say they are more interested in achieving their vision than in making a big profit. But without adequate profitability, you get worn down, burnt-out and discouraged.

An unprofitable business fails unless outside money is continually pumped in. You cannot make the contribution you want without bringing in a good profit.

The uses of profit

As your attitude toward profit shifts from (a) what's left over that you use to pay yourself, to (b) a resource you use for critical business needs, you can plan your operations so that they regularly generate profit beyond what you pay yourself. You can create a profit budget to calculate how much you need to cover such items as:

Fund for expansions or upgrades. How much do you need to set aside each year for anticipated upgrades and expansion?

Cushion to cover downturns. How much should you set aside each month to provide an insurance policy against short-term financial reverses?
Fund for bonuses and financial incentives and profit sharing. What proportion of sales revenue should you allocate to incentives and bonuses in order to motivate top performance?

Retirement programs. What proportion of salaries and wages should you set aside to fund retirement plans for you and your employees?

Paying taxes. How much must you set aside each month to pay taxes on the profit you anticipate?

Debt repayment. How much cash flow must be available after taxes to pay down your debt including repayment of money you have put into the company? Calculate all these amounts that pertain to you and add them up. This is the amount of profit from operations you need each year. If you divide this sum by your projected revenue, you get a percentage that shows what proportion of each dollar of sales revenue should be available for these uses. One of the most important uses for this percentage is to set prices that assure the desired level of profitability.

Your accountant may gnash his or her teeth over the above paragraph, correctly pointing out that many of these items are business expenses, not profit. I agree. However, for small business owners who are trying to make a transition from a cover-the-costs mentality to a generate-surplus mentality, developing this profit budget is invaluable. These are the very items that they otherwise fail to account for in their planning, their projections and their pricing decisions.

Need help?
Several of our books, workshops, and e-tools help you boost your profitability and to figure out how much profit you need. These include:
How to Grow Your Business without Driving Yourself Crazy, esp. Chapter 13, Build a Culture of Profitability and Chapter 15, Calculate the Benefit and Cost.

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